SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

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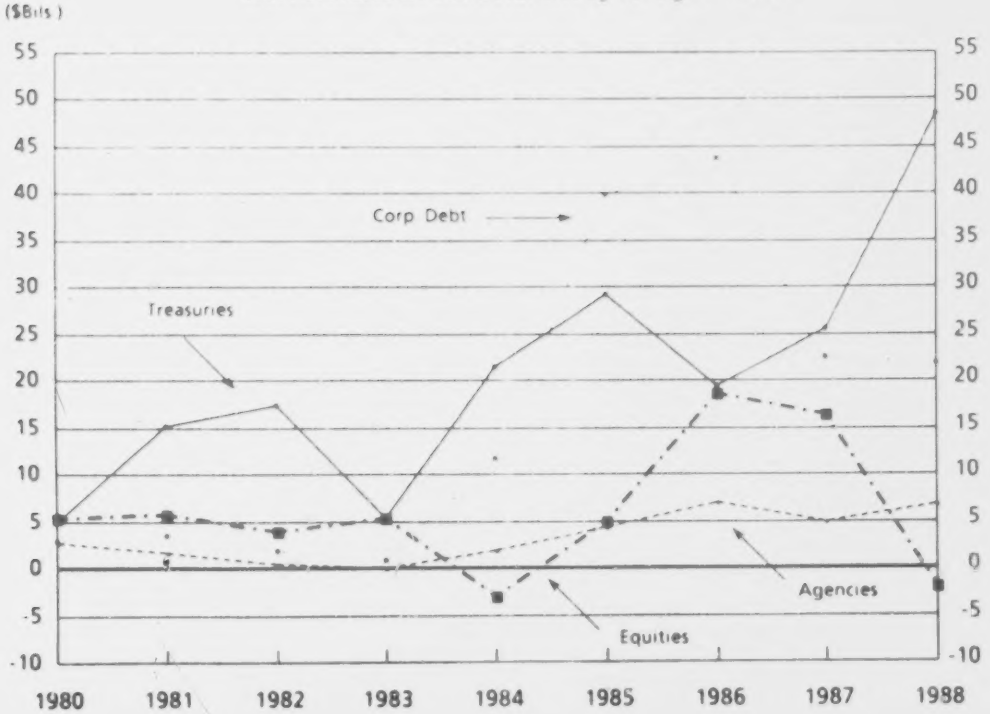
Foreign Investment In U.S. Securities: A Change of Heart

Despite worries that the crash and a weak dollar might dissuade foreign investors in 1988, investment in United States securities of all kinds reached its third highest level, $75 billion, and exceeded 1987's $69.4 billion. While 1988's net purchases are only 8% above 1987, foreign investors' preferences for securities showed a distinct change. In 1987, foreign equity purchases accounted for nearly 24% of portfolio investment while fixed income purchases accounted for 76%. The crash had a lasting impact; after net purchases totalling $35 billion in 1986 and 1987, or 22% of portfolio flows, foreign investors were net sellers of equities in 1988. In light of net sales of U.S. equities, fixed-income securities accounted for over

Net Purchases Of U.S. Securities By Foreign Investors



100% of total net purchases. Further, of fixed-income purchases, nearly 65% were in U.S. Treasuries, contrasting sharply with the 34% average for the last three years.

Foreign Investment in U.S. Equities: Caveat Emptor

For the first time since 1984, foreign investors were net sellers of U.S. equities. With foreign investors buying stocks in other equity markets, uncertainty about the dollar had to be a major concern for those foreign investors interested in U.S. equities. Although the U.S. stock market staged a modest rally in December, foreign investors headed home, or to other more promising markets, with net sales of $1.2 billion of U.S equities. Hence, in the final quarter of 1988, foreign investors were net sellers of a relatively large $2.8 billion of U.S. equities. The two largest foreign investors in U.S. equities led the retreat, with U.K. and Japanese investors making net divestitures of $1.0 billion and $900 million, respectively. Interestingly, U.K. investors made net purchases of over $5 billion of non-U.S. foreign equities in the fourth quarter, emphasizing again that non-domestic equities were attractive, excluding dollar denominated stocks.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1987		1988		% Change 1988 1987
	Gross Activity	Net Purchases	Gross Activity	Net Purchases	Gross Activity
Europe	**$232,464**	**$ 1,932**	**$154,152**	**$ (3,423)**	**(33.7%)**
Belgium-Luxembourg	11,732	435	7,738	134	(34 0)
France	20,055	(905)	12,028	(281)	(40 0)
Germany	16,208	(70)	10,966	223	(32 3)
Netherlands	11,278	892	5,828	(535)	(48 3)
Switzerland	59,533	(1,123)	34,909	(2,242)	(41 4)
United Kingdom	103,909	631	73,235	(1,034)	(29 5)
Canada	**49,947**	**1,048**	**33,941**	**1,088**	**(32.0)**
Latin America & Caribbean	**46,900**	**1,318**	**38,301**	**1,248**	**(18.3)**
Bermuda	10,424	(102)	6,663	55	(36 1)
Netherlands Antilles	15,581	(167)	12,729	385	(18 3)
Asia	**142,361**	**11,535**	**129,624**	**(1,104)**	**(8.9)**
Hong Kong	12,489	658	6,878	(250)	(44 9)
Japan	102,575	11,365	104,601	1,923	2 0
"Other Asia" *	20,545	(1,360)	14,143	(2,466)	(31 2)
Total All Countries	**$481,971**	**$16,272**	**$363,965***	**$(2,062)***	**(24.5)**

Source U S Treasury

* Total activity incorporates revised data, country activity does not incorporate revisions

Given net sales of over $1.0 billion in three months of the year and modest net purchases in six of the remaining months, the result was net sales of $2.1 billion for the year. Thus, foreign investors were net sellers for the first time since 1984, when net sales totaled $3.0 billion. The 1988 investment pattern contrasts starkly with net foreign capital inflows of $16.3 billion and $18.7 billion in 1987 and record-year 1986, respectively. The contrasts are sharp and remind us that foreign portfolio investment will not necessarily provide an unending stream of support for U.S. markets. However, as we'll soon see, foreign investors continue to be attracted to U.S. securities.

TABLE II

FOREIGN NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1988 First Quarter	*1988 Second Quarter*	*1988 Third Quarter*	*1988 Fourth Quarter*
Europe	**$(908)**	**$(637)**	**$(103)**	**$(1,804)**
Belgium-Luxembourg	76	151	(15)	(79)
France	(132)	(33)	(92)	(24)
Germany	201	2	(8)	28
Netherlands	(236)	(244)	(42)	(14)
Switzerland	(399)	(468)	(632)	(757)
United Kingdom	(599)	(137)	732	(1,043)
Canada	**(80)**	**171**	**264**	**734**
Latin America & Caribbean	**217**	**32**	**527**	**284**
Bermuda	(9)	31	33	(12)
Netherlands Antilles	77	73	37	198
Asia	**(130)**	**1,063**	**(94)**	**(1949)**
Hong Kong	(180)	(40)	22	(51)
Japan	1,072	1,544	217	(900)
"Other Asia"	(933)	(463)	(256)	(827)
Total All Countries	**$(759)**	**$588**	**$814**	**$(2,756)**

Source: U.S. Treasury

Despite the lack of interest in adding U.S. equities to their portfolios, foreigners still actively trade U.S. equities. Gross transactions were $364.0 billion in 1988, a drop of 24% from the record $482.0 billion for 1987. Nevertheless, foreign gross activity in 1988 was the second highest figure ever. On a quarterly basis, gross activity peaked in the second quarter of 1988 at $102.8 billion, well below 1987's quarterly average of $120.4 billion. Foreign activity continued to wane throughout the rest of 1988, dropping to $75.6 billion in the fourth quarter. We have to return to 1986 to find similar levels (quarterly average was $70 billion).

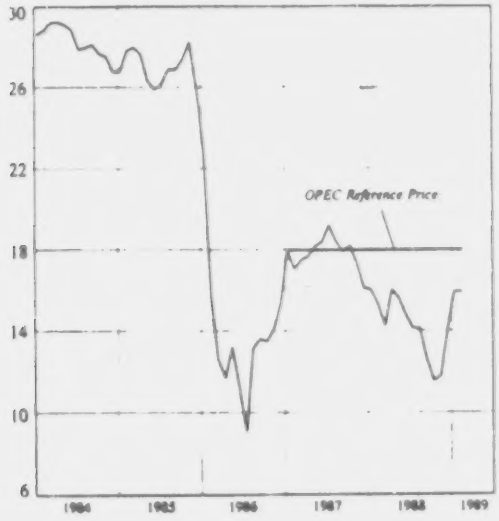
Both European and Canadian investors reduced their activity substantially in 1988, by 33.7% and 37.0%, respectively. Asian investors, however, only decreased their activity by 9%, though this is attributable to Japanese flows. Japanese investors actually increased their activity in 1988, inching up 2% to $104.6 billion. Remarkably, gross activity by Japanese investors alone in 1988 was 68% of that for all European investors; in 1987 this number was at a "mere" 44%.

Japanese investors showed similar prowess in terms of net purchases. While most of their attention was given to the high flying Tokyo market, they still added $1.9 billion of U.S. equities to their holdings in 1988. While down substantially from 1987's record $11.4 billion, Japan was one of only two foreign countries to commit a billion dollars or more to U.S. equity markets in 1988. Canada was the other country, with net purchases of $1.1 billion.

Despite these inflows, foreign investors were net sellers of U.S. stocks for the first time since 1984. Oil exporting countries were the most prolific sellers, reducing their holdings by just under $2.5 billion in 1988. This marked their second consecutive year, for eight consecutive quarters, as net sellers. Since oil prices trended downward in the 1980s, while OPEC countries are devoting increasing resources to modernize their countries, this selling reflected their need for supplemental funds. Data from the International Monetary Fund supports this need.1/

AVERAGE SPOT MARKET PRICE FOR SELECTED CRUDE OILS, 1984-1989

(In U.S. dollars a barrel)



Source: International Monetary Fund, World Economic Outlook, April 1989

1/ OPEC's oil trade balance has plummeted from a $278.8 billion surplus in 1980 to a projected $89.7 billion for 1988. These countries have actually had a current account deficit for six of the last seven years and have seen their investment income cut by nearly half, from 1981 to 1988.

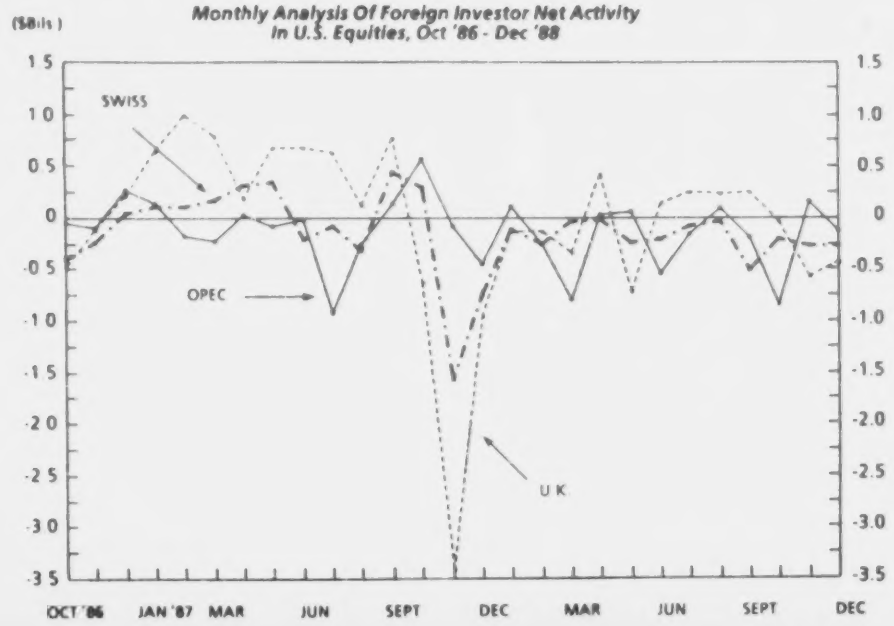
That the crash had a major influence on these investors is debatable. As the table below shows, the crash, if it had any impact on OPEC countries, merely expedited a trend begun earlier in 1987.

Net Purchases of U.S. Equities By Oil Exporting Countries
($Mils.)

4Q	$ (827)
3Q	(256)
2Q	(463)
1Q88	(935)
4Q	(38)
3Q	(1,033)
2Q	(95)
1Q87	(269)
4Q86	125
Total	$(3,776)

Heavy net sellers also included the Swiss, with net sales exceeding $2.2 billion, and U.K. investors, with over $1 billion. In distinct contrast to OPEC investors, however, residents of the U.K. reacted quickly and sharply to the crash. As the graph shows, prior to the crash, U.K. investors had been net purchasers of U.S. equities for 10 consecutive months, from December 1986 to September 1987. The crash of October, 1987 initiated six consecutive months of net sales, totalling $5.6 billion, nearly wiping-out the $5.7 billion in net purchases made during the ten months prior to the crash. U.K. investors, however, have slowly begun to dabble back to U.S. equities.

Swiss investors also reacted to the crash, though, as the graph indicates, some selling pressure may have been building. While Swiss investors did not act as swiftly as U.K. investors, the crash left a more lasting impact. Swiss investors have been net sellers of U.S. equities for fourteen consecutive months through 1988.



Foreign Activity In U.S. Treasuries

Trading of U.S. Treasuries by foreign investors continued to be active in 1988, increasing 16.4% to a record $3 trillion, or almost an unbelievable 31.5 times greater than activity at the beginning of the decade. Japanese investors raised their activity to $1.5 trillion in 1988, a 17% increase over the $1.2 trillion in 1987. Sterling based investors, however, raised their activity in U.S. Treasuries by a whopping 32.1%, from $604.8 billion in 1987 to $798.9 billion in 1988. In net terms, Central bank intervention in the foreign exchange markets and increased interest by private investors, fueled net purchases of U.S. Treasuries to a record $48.5 billion.

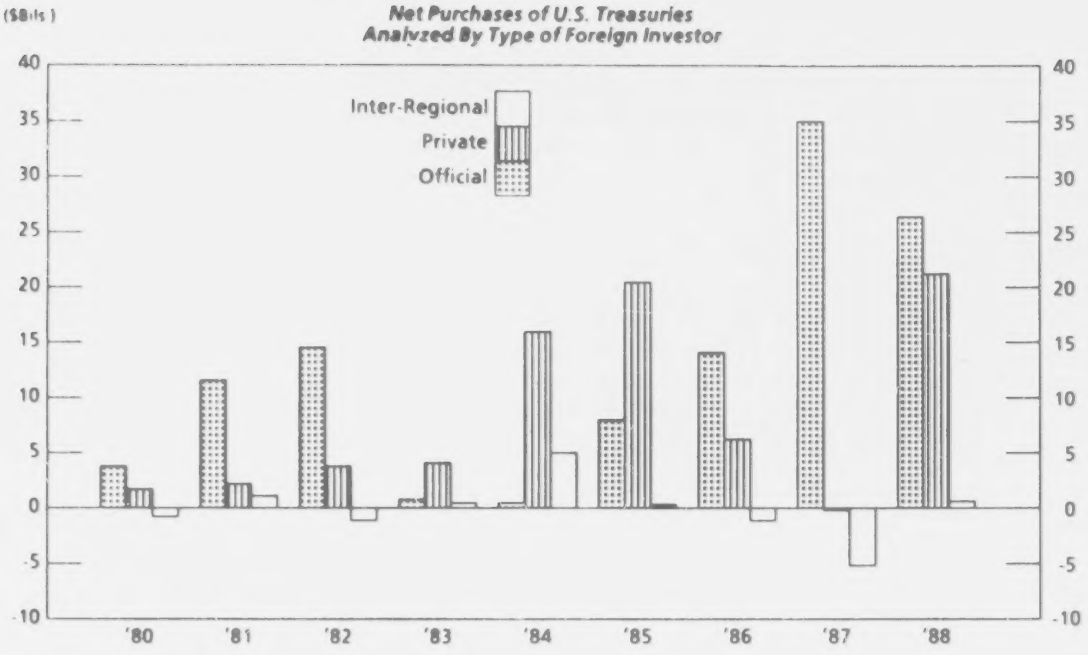
TABLE III

FOREIGN GROSS ACTIVITY AND NET PURCHASES OF
U.S. TREASURY NOTES & BONDS
($ Millions)

	1987		1988		% Change 1988-1987
	Gross Activity	Net Purchases	Gross Activity	Net Purchases	Gross Activity
Europe	**$ 907,856**	**$23,716**	**$1,163,593**	**$14,255**	**28.2%**
Germany	89,670	13,330	79,706	(5,348)	(11.1)
Switzerland	28,279	1,917	24,487	(1,074)	(13.4)
United Kingdom	604,831	3,975	798,901	9,667	32.1
Asia	**1,245,390**	**4,488**	**1,457,103**	**27,357**	**17.0**
Japan	1,050,936	868	1,238,009	21,753	17.8
"Other Asia"	63,414	(3,142)	81,370	1,715	28.3
Nonmonetary Int'l & Regional Organizations	**297,710**	**(5,302)**	**246,117**	**686**	**(17.3)**
Total All Countries	**$2,649,308**	**$25,587**	**$3,083,732**	**$48,529**	**16.4%**

Source: U.S. Treasury

Central bank participation was a major factor again in the U.S. Treasury market. For the third consecutive year, central bank net purchases of U.S. Treasuries exceeded those of the private sector. The efforts by G-7 countries to "fix" exchange rates, as well as to prevent at different times, a further decline, or destabilizing increase, of the dollar, led to substantial intervention. Because of these efforts, central bank net purchases in 1988 totalled a healthy $26.5 billion, albeit $4.6 billion less than 1987's record $31.1 billion. While data is not available, presumably, the increase in central bank net activity has been followed by a similar surge in gross activity.



Moreover, data on official reserves from various central banks further underscore the substantial intervention. In that central banks agreed to stem the ascent of the dollar in late 1985, this period is used as the beginning point in the next table.

Central Bank Intervention Swells
Official Reserves
($Bils.)

	Nov 1988	Dec 1985	% Change
Japanese	$ 97.1	$ 26.5	266.4%
U.K.	51.0	15.5	229.0
W. German	66.2	48.0	37.9
Total G-7	$347.0	$184.5	88.1%

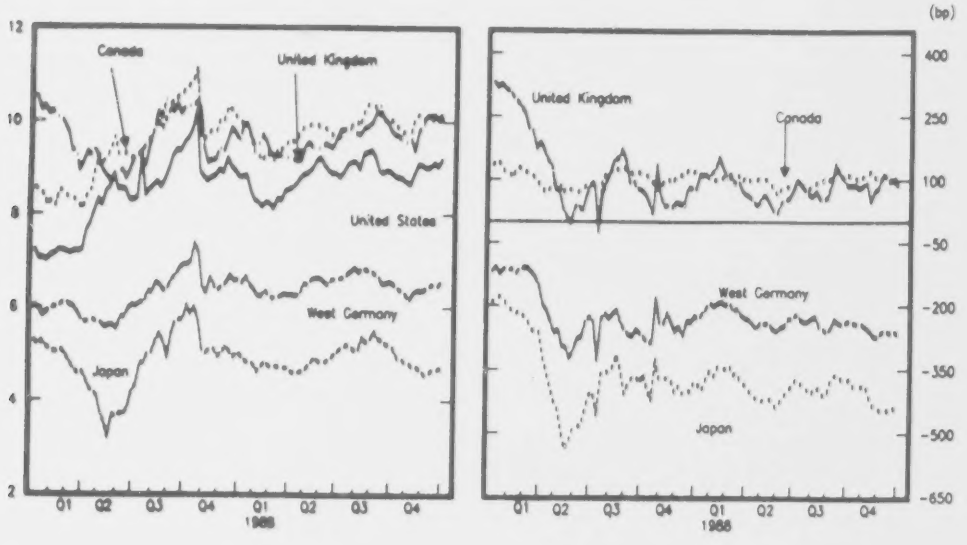
Source: Bank of Japan, Economic Statistics Monthly

This table masks a substantial drop in West German central bank reserves in 1988, reflecting Bundesbank support of the deutschemark. Indeed, a decline of $17 billion in West German reserves in 1988 offset 60% of their reserve accumulation in 1987. As expected, U.S. Treasury data indicate substantial West German net sales of U.S. Treasuries in 1988, over $5 billion; in contrast, West German net purchases totalled $13.3 billion in 1987.

Private investors also joined the U.S. Treasury party in 1988. Following net sales of $200 million in 1987, which reflected private investor concern over central banks' ability to stabilize the dollar, private investors returned to make record net purchases of $21.3 billion in 1988. Since 1987 was the first year since 1972 that private investors were net sellers of U.S. Treasuries, this represented a dramatic reversal.

Indeed, for the last three quarters of 1988, net purchases by private investors totalled $14.2 billion, exceeding the $6.1 for central banks. As the U.S. economy grew faster than anticipated, and yields on U.S. Treasuries topped 9%, foreign investors "snapped-up" U.S. Treasuries. Japanese investors, for instance, saw the yield spread of U.S. Treasuries over Japanese governments increase from around 350 to over 450 basis points from early 1988 to late 1988.

Ten-Year Government Yields and Spreads
Versus Ten-Year U.S. Treasury



Source: Salomon Brothers Inc

U.S. Activity In Foreign Equities:
We Shall Return!

U.S. investors, although approaching overseas markets with caution in the first half, were net purchasers of $1.7 billion of foreign stocks in 1988. In comparison, net activity resulted in sales of $1.1 billion of foreign stocks in

1987 for the first time since 1978. So, until 1987, the trend favored by U.S. institutional investors was to increase their holdings of foreign equities. Indicative of lower turnover rates in 1988, U.S. investors reduced their trading of foreign equities by 20.5% to $150.8 billion. Interest in foreign stock was strongest in the fourth quarter, with net purchases of $1.4 billion, as U.S. investors rushed back into high flying Japanese stocks. U.S. investors divested some $1.6 billion of Japanese stocks in the second and third quarters of the year, but reversed course and made fourth-quarter investments of $1.2 billion. For those steadfast U.S. investors who rode out the Japanese market from year-end to year-end, the return was a hefty 33%. However, a strengthening dollar reduced this return to a 29% gain.

TABLE IV

GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS

	1987		1988		% Change 1988-1987
	Gross Activity	Net Purchases	Gross Activity	Net Purchases	Gross Activity
Europe	**$101,406**	**3,484**	**75,445**	**1,279**	**(25.6)%**
France	6,148	(178)	4,008	402	(34.8)
Germany	8,651	(399)	4,525	239	(47.7)
Netherlands	5,170	38	3,974	(206)	(23.1)
Switzerland	6,313	739	5,309	521	(15.9)
United Kingdom	67,892	3,274	51,213	403	(24.6)
Canada	**18,857**	**2,357**	**9,645**	**(477)**	**(48.9)**
Asia	**56,693**	**(7,257)**	**55,846**	**822**	**(1.5)**
Japan	47,784	(6,490)	40,158	634	(16.0)
Other	**12,879**	**335**	**9,906**	**(110)**	**(23.1)**
Total All Countries	**$189,835**	**$(1,081)**	**$150,842**	**$1,514**	**(20.5)%**

Source: U.S. Treasury

* Total activity incorporates revised data, country activity does not incorporate revisions

Strong economic growth in Europe and a 10% gain in European equity prices in 1988 was not enough to convince U.S. investors to step-up their commitment to European equities. U.S. investors' appetite for European equities waned, as they slashed activity by 25.6% and net activity by close to three times. Part of this explanation may lie in a recent report, which noted that "recent data on cross-border equity flows confirm that international investors have been overweighting Europe within global equity portfolios."[2]

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[2] Salomon Brothers Inc, Global Equity Investment Strategy

Hardest hit were U.K. equities, where U.S. investors reduced their net acquisitions from $3.3 billion in 1987 to $403 million in 1988. A deteriorating trade balance, inflationary expectations and rising interest rates was enough to send U.S. investors to other markets.

Equity Market
Returns For U.S. Investors
(U.S. Dollars)

	% Change Dec. 87-Dec. 88
Europe	**9.6%**
France	33.6
Germany	13.8
Netherlands	12.1
Switzerland	(6.5)
United Kingdom	2.1
Canada	**13.7**
Asia	**35.1**
Japan	35.4
World ex. U.S.	**25.7**
U.S.	**12.6**

Source: Goldman Sachs/FT-Actuaries World Indices

It seems that the U.S.-Canadian Free Trade Agreement failed to inspire U.S. investors, who decreased their activity in Canadian equities by nearly 50%, from $18.9 billion in 1987 to $9.6 billion in 1988. Moreover, U.S. investors reduced their holdings of Canadian equities by $477 million, one year after net purchasers of $2.4 billion. This is consistent with official data sources in Canada, which indicate that since the crash, foreign investors have made net sales of close to C$3 billion in Canadian equities (with net purchases of a record C$8.3 billion of Canadian bonds). Despite a deterioration in Canada's current account balance, the Canadian economy has not been marked with any significant bad economic news. This market is still facing the lingering negative impact of the 1987 crash.

The run-up in the Japanese market, though, has encouraged foreign investors to seek Japanese equities. Following net sales of $6.5 billion in 1987, U.S. investors did an about-face and made net purchases of $634 million; and were handsomely rewarded with a return of over 28%.

Finally, the graph below indicates that increase in gross flows during the 1980s has been followed by dramatic increases in the size of U.S. investor net flows into, and out of, foreign markets. Prior to 1985, capital flows into the equity markets of the countries analyzed ranged monthly from approximately net purchases of $500 million to net sales of $500 million.

Post-1985 flows have been much more erratic, ranging from net sales of nearly $3 billion to net purchases of $1.5 billion, on a monthly basis. Such dramatic shifts in capital flows indicate that U.S. investor's impact on overseas equity prices may be increasing and therefore the monitoring of such movements is all the more important for equity markets throughout the world and global money managers.

Net Purchases Of Foreign Stocks By U.S. Investors: The Increasing Magnitude Of Net Flows

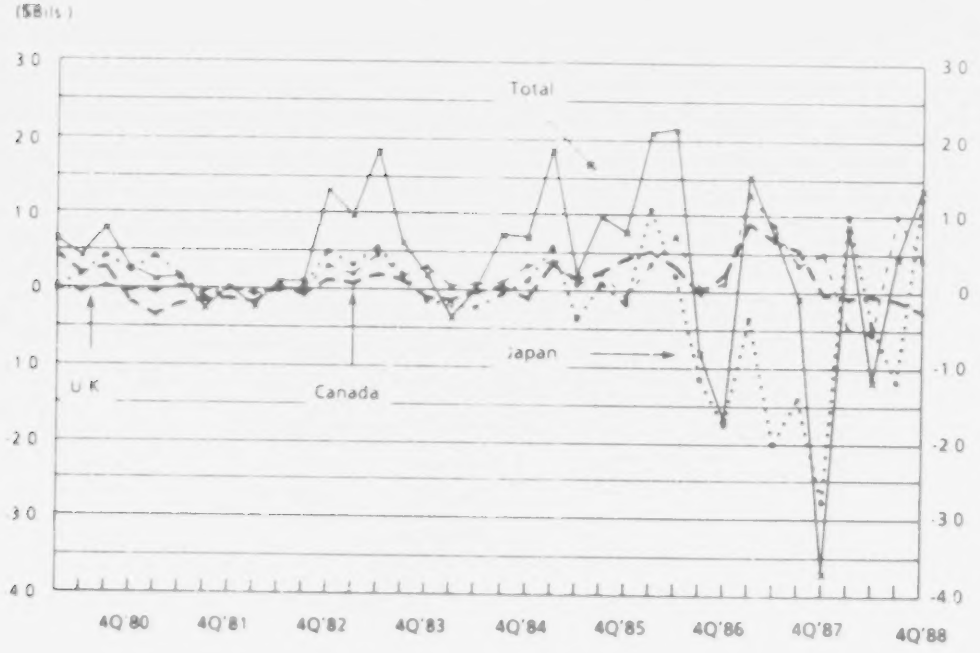

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TABLE V

GROSS TRANSACTIONS IN & NET PURCHASES OF
U.S. CORPORATE BONDS
($ Millions)

	1987		1988		% Change 1988-1987
	Gross Activity	Net Purchases	Gross Activity	Net Purchases	Gross Activity
Europe	**$ 76,924**	**$20,132**	**$51,830**	**$15,149**	**(32.6)%**
Belgium-Luxembourg	3,132	(312)	2,104	(171)	(32 8)
France	2,219	209	2,334	75	5 2
Germany	4,879	(203)	4,053	990	(16 9)
Switzerland	6,353	1,623	3,740	346	(41 1)
United Kingdom	55,730	18,309	35,226	12,452	(36 8)
Asia	**16,936**	**480**	**24,964**	**5,068**	**47.4**
Japan	12,407	513	24,330	4,864	96 1
"Other Asia"	3,294	(215)	2,226	(204)	(32 4)
Total All Countries	**$103,562**	**$22,497**	**$87,702**	**$21,914**	**(15.3)%**

Source U S Treasury